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IN THE

Supreme Court of the United States

October Term 1956

No. 1019

241 CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PFTITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

AND APPENDIX

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IN THE

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241 CORPORATION, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. ....

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on March 28, 1957.

Citations to Opinion Below

The memorandum opinion and findings of fact of the Tax Court of the United States is reported in T. C. Memo. 1956-174. The opinion of the United States Court of Appeals for the Second Circuit, not yet officially reported, affirmed the decision of the Tax Court of the United States on March 28, 1957 on the basis of the opinion of Tax Court Judge Rice.

Jurisdiction

The United States Court of Appeals for the Second Circuit, having affirmed the decision of the Tax Court of the United States on March 28, 1957, jurisdiction of this Court is invoked in accordance with Title 28, U. S. C. Section 1254(a).

Question Presented

Is accrued interest on loans made by stockholders to the petitioner, a real estate corporation, or any part thereof deductible in accordance with Section 23(b) of the U. S. Internal Revenue Code of 1939, for the fiscal years ended 6/30/1946, 6/30/1947 and 6/30/1948, where the Tax Court has found as a fact that the advances by the stockholders were intended as loans and the stockholders and the corporation so regarded and treated them?

Statute Involved

Statute and Regulations applicable to this proceeding are set forth in the appendix attached hereto.

Statement

Petitioner duly filed its petition with the Tax Court of the United States for a redetermination of its income tax liability for the fiscal years ended June 30, 1947 and June 30, 1948, as set forth in deficiency notice of the Commissioner of Internal Revenue dated May 17, 1954.

The Tax Court filed its Findings of Fact and Opinion on July 25, 1956 and entered its decision on August 6, 1956.

Petitioner filed its petition for review with the United States Court of Appeals for the Second Circuit on August 23, 1956. The United States Court of Appeals for the Sec-

ond Circuit affirmed, per curiam, the decision of the Tax Court of the United States on March 28, 1957.

The Tax Court of the United States determined that interest accrued on loans by stockholders to the petitioner, a real estate corporation, which filed its returns on an accrual basis, was not deductible as interest since the advances were held to be capital contributions.

The Tax Court found petitioner was organized July 31, 1945 under the laws of the State of New York to acquire title to certain real estate located at 241 and 248 Central Park West, New York, N. Y.

The organizers consisted of Samuel Rudin, Edward Rudin, Jacob R. Schiff, Manuel Sydney and Seymour Gross. Except for the Rudin brothers, none of the participants were related to one another and only the Rudins were exclusively in the real estate business.

The total purchase price of the two properties acquired, exclusive of adjustments, was $1,842,478.27.

The Tax Court found it had been the intention of the Rudins, who conceived the idea of organizing the corporation, to limit the amount of money which they and the others had to advance in order to acquire these properties to a total of $50,000, of which $3,000 was to be capital and $47,000 loans (C. R. 4, 5).

The Tax Court further found that the Rudins planned to have petitioner assume existing first mortgages of $1,542,478.27 due in July 1954 and, in addition, to raise a second mortgage of $250,000, which represented the balance of the purchase price. To this end the Rudins sought the aid of Jacob Schiff, an attorney, who specialized in making or obtaining second mortgage loans and who agreed to participate in the venture and to obtain such $250,000 second mortgage. On the basis of Schiff's promise, a preliminary

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C. R. = Certified Record.

contract of purchase was entered into in June 1945 with a deposit of $20,000 (C. R. 5).

In July 1945, just prior to taking title, Schiff found he could obtain a $150,000 second mortgage from Standard Factors Corporation with interest at 10% per annum. As a result, participants had to decide whether to advance the additional $130,000 and take title to the properties, or forfeit the deposit of $20,000. The participants decided to proceed with the purchase after having been assured by Samuel Rudin on the basis of an estimate of the rentals and expenditures including amortization of existing mortgages (which estimate was made prior to the purchase of the property) that the advances could be repaid by 1951. Rudin's estimate showed that the properties would reflect a net cash excess of rentals over expenditures of $78,000 per annum.

It was always the intention of the stockholders in making the advances that such advances of $147,000 represented loans and were to be repaid by about 1951.

The stockholders would not have entered into the business transaction of having petitioner acquire the 241 and 248 Central Park West properties unless the advances could be treated as loans instead of capital contributions, and repaid before the first mortgage was due.

The $50,000 paid in to petitioner by the Rudins represented funds borrowed by them which had to be repaid within four years.

Petitioner issued shares of stock and recorded the advances on its books as loans payable, as follows:

Name	No. of Shares	Amount	Advances
Samuel Rudin	5	$ 500	$ 24,500
Edward Rudin	5	500	24,500
Manuel Sydney	5	500	24,500
Seymour Gross	5	500	24,500
Jacob R. Schiff	10	1000	49,000
	30	$3000	$147,000

The stockholders insisted that the funds should be treated as loans for the reason they feared the Consolidated Realty Corporation, a subsidiary of the Reconstruction Finance Corporation, the holder of the first mortgage, would not renew its mortgage when it fell due in July 1954, and if refinancing could not be obtained, the funds might be completely lost unless treated as loans and repaid before the due date of the first mortgage (C. R. 6).

Both the corporation and the stockholders treated the advances as loans and the financial and corporate records of the petitioner reflected said advances as loans (C. R. 7, 9).

The authority to borrow the money from the stockholders was set forth in the minutes of the Board of Directors of the corporation which authorized the loans to be made on demand at a 10% annual interest rate. This was the same interest rate as paid to Standard Factors Corporation (C. R. 6, 7, 9).

Additional loans were made by the stockholders to the petitioner as the needs of the business required and were repaid. Interest at the rate of 10% per annum was also charged on said loans (C. R. 7, 9).

None of the loans at issue was subordinated to the claims of creditors and all loans were repaid by January 7, 1952 (C. R. 7).

Petitioner paid off the principal of the loans from stockholders as frequently as it could, thus reducing interest charges (C. R. 9).

Petitioner made all the regular payments on its mortgage loans. It paid off the second mortgage held by the Standard Factors Corportion in November 1946. A loan negotiated with the Lawyers Trust Company to pay off the Standard Factors Corporation mortgage was reduced by regular payments and was itself paid off by June 30, 1948 (C. R. 8).

The Consolidated Realty Corporation was insisting on regular payments of interest, amortization and monthly installments of real estate taxes in advance, upon threat of foreclosure (C. R. 8). To avoid this situation, the taxpayer in 1947 refinanced the first mortgage held by the Consolidated Realty Corporation by obtaining a new first mortgage in the amount of $1,200,000 at an interest rate of 4%, which mortgage was obtained from the Prudential Life Insurance Company, and the proceeds were used in reduction of the amount owing to the Consolidated Realty Corporation, which accepted a second mortgage for the balance of $254,993.40, the rate of interest being the same and the due date being the same as on the original first mortgage (C. R. 8).

The Tax Court also found that in filing their Federal income tax returns, Edward and Samuel Rudin treated the repayment of their advances by the corporation as repayments of loans during the years 1948 to 1952 inclusive (C. R. 9). It has been stipulated that the Commissioner of Internal Revenue, in examining the Rudins' returns for the years of repayment, accepted the treatment accorded (except 1951—open on a waiver of statute of limitations) to these repayments by the individuals.

It has been stipulated between the parties that the Estate of Jacob Schiff (deceased January 10, 1949) treated these advances as loans receivable and reported the interest accrued on such loans receivable as part of its assets, both on its Federal Estate and New York State Inheritance tax returns as well as in its Surrogate's Court accounting.

The Tax Court further found that the amount of interest claimed on loans during the fiscal years ended June 30, 1946, June 30, 1947 and June 30, 1948 was $14,709.49, $17,371.16 and $17,995.84 respectively (C. R. 10), and that none of the accrued interest set up for these years was paid off during such years because petitioner did not have sufficient funds

(C. R. 9). However, the petitioner did pay, between January 7, 1952 and May 12, 1952, $16,623.97 of the accrued interest payable (C. R. 9, 10).

The Tax Court was of the opinion that the advances made by Messrs. Rudin, Schiff, Gross and Sydney were in fact capital investments in the nature of preferred stock and that the interest accrued on such advances was not deductible (C. R. 14).

Reasons for Granting Writ of Certiorari

The Court below, in affirming the decision of the Tax Court, stated it did so on the basis of the opinion and finding of fact by Judge Rice, of the Tax Court.

Judge Rice correctly stated the question was one whether the parties intended to create and did create a true debtor-creditor relationship.

The Tax Court, on the basis of the evidence, did find that the stockholders intended their advances to be loans; that the corporation was authorized to make the borrowings by corporate resolution and to pay a rate of 10% per annum until the loans were repaid; that the corporate and financial records of the petitioner did reflect the advances as loans; that the stockholders also recorded and treated the advances as loans; that interest was accrued on such loans and reflected on petitioner's Federal tax returns and on petitioner's books and records; and that the advances were repaid.

The Tax Court found the intent of the parties to the questioned transactions was to create the relationship of debtor-creditor as is evident from the following statements made by the Court in its findings of fact and opinion:

> "It had been the intention of the Rudins, who conceived the idea of organizing the petitioner, to limit the amount of money which they and the other stock-

holders would have to advance in order to acquire and operate the Central Park West properties to a total of $50,000, of which $3,000 was to be considered as capital and $47,000 as a loan. They planned to have petitioner assume existing first mortgages on the properties, aggregating $1,542,478.27, and to raise the balance of the purchase price by means of a $250,000 second mortgage. To this end they sought the aid of Jacob Schiff, who agreed to participate in the venture and to obtain a $250,000 second mortgage for petitioner. On the basis of Schiff's promise, a preliminary contract for the purchase of these apartment buildings was written on June 1, 1945, and the participants placed a $20,000 deposit on the property.

"In July or August 1945, Schiff found that the largest second mortgage which he could obtain on the properties was $150,000. The participants decided to proceed with the purchase by increasing the amount which they would advance from $50,000 to $150,000. Of this sum, $3,000 was to be capital and $147,000 was to be regarded as a loan." (C. R. 4, 5)

"The stockholders intended that petitioner repay all advances out of earnings before July 31, 1954, which was the due date of the $1,524,728.27 mortgage held by Consolidated Realty Corporation. They feared that this mortgage would not be renewed and that, if another mortgage could not be obtained, their total investment in the property would be lost. They estimated that all advances to petitioner could be repaid out of earnings by 1950 or 1951. (C. R. 6)

* * * * * * *

"The reason given by the participants in this venture for the limitation of their capital investment to $3,000 was that they considered the venture to be a highly speculative one which might result in the complete loss of such portions of their investment which were not repaid prior to July 31, 1954, the due date of the $1,524,728.27 mortgage on the property, if

that mortgage was not renewed or refinanced. However, *we do not think this intent determinative of the issue herein.*" (C. R. 10) (emphasis supplied)

While the Tax Court thus stated that "this intent (was not) determinative of the issue," it nevertheless set up the following criteria, which in fact are merely for the purpose of arriving at intent:

(a) No notes or security were given by petitioners on such loans and no date was specified for their payment;

(b) Advances were made by stockholders in exact proportion to their equity interests in the corporation;

(c) The debt ratio to capital was greatly disproportionate.

(d) Repayments of advances were dependent on petitioner's future earnings.

(e) No fixed date of repayment.

(a) The failure to issue notes or give security as evidence of a debt does not prevent a bonafide indebtedness from being created.

In this case the corporation acknowledged its debt by corporate resolution, reflected the debt in its financial books and on its tax returns, and the individual stockholders did likewise, and the *debt in fact was repaid.*

While it is perfectly clear that the issuance of Notes is evidence of a debt, and thus eases the burden of proving a debt, there are other methods of establishing a debt, such as by letter, I. O. U., corporate resolution, financial books and corporate records, and even oral acknowledgments.

In the case of *National Lead Company* v. *Commissioner of Internal Revenue* (1955), 23 T. C. 988, the petitioner had advanced between 1923 and 1943 a sum in excess of

$5,000,000. The books of the petitioner and of the debtor reflected these advances as loans; no demand had been made on the debtor prior to 1943 for the return of the loans. Interest was not even demanded nor required. Nevertheless the Tax Court found that the intent of the parties was to be given effect despite the fact that the debt was not evidenced by a note nor was the debt secured. The Tax Court stated that National Lead Company was unwilling to purchase stock or make capital contributions to the debtor. The advances were loans in form and were so recorded and accounted for throughout and there was positive testimony that they were intended as loans.

Although in the instant proceeding we have similar facts and similar standards for determining whether an advance is a debt or capital contribution, different judges in the same Court arrived at directly opposite results.

In *Rowan et al* v. *United States* (1955), 219 F. (2d) 51 (CA-5), the petitioners advanced over a period of years amounts in excess of $125,000, which were reflected on the books of the corporation as loans payable. On liquidation of the corporation, petitioner claimed a loss as a result of the liquidation of the corporation and the failure to recover the full amount of the advances. The Circuit Court, in reversing the District Court, held that the loans had to be so regarded as the intent of the parties was to create an indebtedness. Here again no notes or security were issued by the debtor corporation as evidence of the debt. This is but another case where another circuit held that the failure of the debtor to issue notes or give security to the creditor was not determinative of the question whether a debt was intended.

In *Wilshire & Western Sandwiches, Inc.* v. *Commissioner of Internal Revenue,* (1949) 175 F. (2d) 718, the U. S. Circuit Court of Appeals for the 9th Circuit held that unsecured advances made by stockholders to construct a

restaurant, which were not represented by notes, were nevertheless loans on the basis of the intent of the parties, that the stockholders wished to participate with general creditors for part of their investment in the business in the event petitioner's business was not successful.

Thus, the Tax Court on occasion and Appellate Courts have held that the absence of a note or collateral does not change a debt to a capital contribution.

(b) Advances made by stockholders in exact proportion to equity interests may nevertheless be bonafide loans.

The Tax Court's second reason for denying the interest deduction, i.e., that the advances were made by stockholders in exact proportion to their equity interest in the corporation, has been specifically repudiated by certain Appellate Courts, the Tax Court itself on other occasions and the United States District Courts. The U. S. Court of Appeals for the 9th Circuit in *Wilshire & Western Sandwiches, Inc.*, supra, accepting the fact that the advances by stockholders to petitioner were made in exact proportion to their equity interest, nevertheless allowed the advances to be treated as loans and found them to be deductible as bad debts.

In *Pierce Estates, Inc.* v. *Commissioner*, (1952) 195 F. (2d) 475, the U. S. Court of Appeals for the 3rd Circuit allowed interest on loans to stockholders though the loans were in exact proportion to stock ownership.

In the case of *Associated Investors, Inc.* v. *United States*, (U. S. Dist. Ct. Kansas, K. C.-723, Dec. 19, 1956) the Court allowed a deduction for interest on advances even though the advances were made at the same time as the stock was acquired and in the exact proportion to equity interests. The Court stated that in making its decision, it was guided by the fact that the U. S. Court of Appeals for the 10th Circuit had adopted the rule that the *intent* of the stockholders governed. The advances in that case were all

made to acquire real estate. To the same effect is the decision of the U. S. District Court N. Dist. of Ohio, E. Div., in *Ruth Moll et al* v. *Carey,* Nos. 31227-30, 2/25/57.

The Tax Court in the cases of *Cleveland-Adolph Mayer Realty Corporation* v. *Commissioner of Internal Revenue,* (1946) 6 T. C. 730, and *Charles Schaeffer & Sons, Inc.,* (1950) T. C. Memo Docket 24160 determined that interest on loans by stockholders were deductible despite the fact that the loans were not collateralized and were in direct proportion to the equity interest of the stockholders.

In the case of *George J. Schaeffer* v. *Commissioner of Internal Revenue* (1955), 24 T. C. 638, the Tax Court allowed a 100% stockholder to deduct his advances as bad debts. The U. S. Court of Appeals for the 2nd Circuit (Jan. 10, 1957), 240 F. (2d) 381, reversed holding the loan to be a non-business bad debt rather than a business bad debt, but in so doing recognized loan treatment.

Likewise in the case of *Maloney* v. *Spencer* (1949), 172 F. (2d) 638, the U. S. Court of Appeals for the 9th Circuit allowed advances to be deducted as bad debts even where the taxpayer was a 100% stockholder. In *National Lead Co.* v. *Commissioner,* supra, a 90% stockholder was allowed to treat substantial advances as loans.

All these cases illustrate that advances will be treated as loans if intended to be loans and the fact that advances are made in proportion to stockholdings does not prevent such advances from being treated as loans and interest thereon from being deducted on income tax returns, or if bad, prevent such advances from being deducted as bad debts.

(c) A disproportionate relationship between capital and loans (thin corporation) does not in itself transmute loans into capital.

The third reason assigned by the Tax Court for not allowing interest on loans was that the debt ratio to capital

was greatly disproportionate. This very tenet has been repudiated by various U. S. Courts of Appeal.

Thus, in *Rowan et al* v. *United States,* 219 F. (2d) 51, 54, 55, the U. S. Court of Appeals for the 5th Circuit reversed the U. S. District Court, and held that unsecured advances to a corporation owned by petitioner and his wife were to be allowed as bad debts. The Court stated:

> "We nevertheless have seen no authority for the proposition that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit. If they make such a determination and it is clear that such is their intent, the fact that when they close up the venture and take the loss as to such amount as they have actually loaned the corporation, this leaves them in a position to enjoy more favorable deduction privileges than if they had put it in as capital, this does not entitle the Commissioner of Internal Revenue to re-write their balance sheet for them and show to be capital what was intended to be a loan.
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> * * * * *
>
> * * * But the Court also recognized that, entirely without reference to the incidence of taxes, stockholders of corporations have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent, always thus reserving the right to share with other creditors a distribution of assets if the enterprise fails. It would obviously work an unwarranted interference by the Courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation. No stockholder could safely advance money to strengthen the faltering steps of his corporation (which, of course, may be

> greatly to the benefit of other creditors) if he is faced with the danger of having the Commissioner, with the backing of the Courts, say, 'he had no right to launch a corporate business without investing in it all the money it needed, and investing it in the way that is most disadvantageous to himself, both as relates to taxation and as to other creditors.' "

To the same effect is the decision in *Giblin* v. *Commissioner of Internal Revenue,* (1955) 227 F. (2d) 692, where the capital was $500 and stockholder loans in excess of $50,000.

The decision in the case of *Maloney* v. *Spencer,* 172 F. (2d) 638, is to the same effect, thus adding the 9th Circuit to that of the 5th.

In *Estate of Herbert B. Miller et al.* v. *Commissioner,* (1956) 239 F. (2d) 729, the Court again reiterated the statement of principle set forth in the *Rowan* case.

Even the Court of Appeals for the Second Circuit in the case of *Kraft Foods Co.* v. *Commissioner of Internal Revenue,* (1956) 232 F. (2d) 118, challenged the right of the Commissioner to refuse to allow an interest deduction on an indebtedness owed to a 100% parent corporation on the theory that the petitioner was a "thin" corporation.

For reasons that remain unstated, the Second Circuit in the instant proceeding refused to follow its decision in the *Kraft Foods* case that intent controls the issue. This is particularly inexplicable since Judge Medina expressed his amazement at the action of the Commissioner of Internal Revenue, stated the intent of the stockholders to effect loans was clear and that he, as an attorney, had organized thousands of corporations in the same manner as the petitioner was organized, and no one ever challenged the set-up of these corporations as not being bonafide. Unfortunately, the opinion of the Court below was strangely silent on this point.

(d) The right of a corporation to deduct interest on advances is not affected by the corporation's need for earnings to repay loans.

The Court below assigned as a further reason for denying the interest deductions the fact that the repayment of advances depended on petitioner's future earnings.

The fact that loans could only be repaid out of rentals does not provide a basis for holding that the loan is capital and repayments of such loans constitute dividends or return of capital. It is normal for real estate loans to be repaid from net cash rentals and, in fact, such cash rentals are the very source of funds for amortizing mortgages on real property.

Even in the extreme situations of interest being paid only if earned, we find U. S. Courts of Appeal in other circuits and the Tax Court in other cases holding contrary to the lower Courts in this case. See *Pierce Estates, Inc.* v. *Commissioner of Internal Revenue,* supra; *Zimmerman Steel Co. et al.* v. *Commissioner of Internal Revenue,* (1942) 130 F. (2d) 1011; *Commissioner of Internal Revenue* v. *O. P. P. Holding Corporation,* 76 F. (2d) 11. In the latter case, the Second Circuit Court affirmed the Tax Court decision, allowing accrued interest on debenture bonds where the interest was payable out of earnings, the Court stating the rule of law to be:

> "The final criterion between the creditor and shareholder we believe to be the contingency of payment."

The Court below has now disregarded this precept laid down by an earlier Court of its own circuit.

The Tax Court itself has long held that an accrual basis taxpayer could only deduct interest in the year in which it accrues. It is the certainty of the obligation to pay and not the ability of the obligor which determine the right to the

deduction. *Panhandle Refining Co.* v. *Commissioner of Internal Revenue,* (1941) 45 BTA 651; *Northwestern Pennsylvania Gas Corporation* v. *Commissioner of Internal Revenue,* (1944) T. C. Memo Op. Docket No. 485.

(e) A stated specific maturity date is not required to establish a valid loan.

The Courts below overlooked that it is common business practice to make open loans which do not specify a fixed maturity date. Such loans are payable on demand. The fact that the demand is not made does not mean there is no due date. This issue is academic since it is agreed that the loans, in fact, were repaid. The Court also overlooked its own fact finding "the stockholders intended petitioner repay all advances out of earnings before July 31, 1954 * * * they estimated that all advances to petitioner could be repaid out of earnings by 1950 or 1951". We there have early and late maturity dates. The late date was a must or all was expected to be lost. In *Tennessee Co.,* 40 B. T. A. 154, affirmed (U. S. C. A.-3, 1940) 111 F. 2d 678, the Board sustained taxpayer's contention that promissory notes represented indebtedness and not capital although said notes had no fixed maturity dates.

Petitioner's position on the facts and law of the case may be summarized as follows:

1. The parties were competent to contract an indebtedness.
2. The parties intended to create an indebtedness. This intent is obvious throughout the record and in fact has been found by the Tax Court. Such desire or intent was motivated by true business purpose on the part of both creditor and debtor. The creditors wanted to assure a means of getting back their advances before the first mortgage became due in 1954, which mortgage they knew would not be renewed.

They would not have advanced the money on any other conditions. In fact, the Rudins had to borrow from a third party all of the original money they lent petitioner. In effect, the Rudins were only a conduit for the loans. As for the corporation, it had to borrow or it could not obtain the funds.

3. The parties performed consciously and purposefully the legal acts that establish a debt. The advances were loans in form, so recorded on the books and in the minutes of the corporation and were so regarded and accounted for by all the parties throughout the period of their existence—by repayment, in tax returns, and estate accounting. There was no subordination of the questioned indebtedness to general creditors, which condition would have to exist in case of capital contribution.

4. The absence or presence of certain form factors are not fatal to the existence of indebtedness.

   (a) Indebtedness need not be evidenced by promissory notes or secured with collateral.

   (b) "Thin capitalization" is only indicative of intent and not determinative of it.

   (c) Loans may be pro rata to stockholdings.

5. Where there are features looking both ways on the question of loans or capital, *the intent of the parties at the time of entering the transaction is the chief determining factor.*

6. Taxpayers need not choose that form of corporate set-up that is most costly to them. The Tax Court was of the opinion that petitioner could have achieved the same result by issuing redeemable preferred stock. Such contention is incorrect since such an arrangement would not have returned the advances intact to the creditors. Without a partial liquidation of the business, which was not happening, the pro rata redemption of preferred stock would have

> resulted in taxable dividends to the extent of corporate surplus and the creditors could not have recovered their advances. Under such circumstances, the corporation could not have obtained the loans necessary to purchase the property. Be that as it may, there is no requirement in the law that taxpayers must so arrange their affairs that they pay the maximum tax. The Supreme Court specifically repudiated such thinking in *Gregory* v. *Helvering*, 293 U. S. 465.

From the foregoing recital it is quite evident that the Courts below made errors of law in not giving effect to the intent of the parties specifically found by the Tax Court, and in assigning reasons for the disallowance of interest deductions that other Circuits Courts have repudiated. Even the Tax Court and the Court below are divided among their divisions in determining the applicable principles.

In the field of Federal taxation, the whole subject of when an advance is a loan and when capital, is in such a state of confusion among the various Circuits as well as in the Tax Court and in the U. S. District Courts, that no responsible attorney can advise his client with certainty whether a given transaction will create a valid indebtedness recognizable for tax purposes, the interest on which will be deductible by the debtor, or whether the advances will be treated as capital, the return of which to the creditor may result in a dividend to the extent of the stockholder's pro rata share of the surplus.

In a most interesting and informative article in the April 1957 issue of the New York University Law Review, the authors, Messrs. Harry J. Rudick and Ira Wender, Professor and Lecturer of Law at New York University, respectively, in discussing this problem made this observation: (p. 770)

> "The difficulty with this approach to the question of the existence of a bonafide debt to stockholders is that in particular situations it is difficult to advise with certainty whether a debt obligation will in fact be treated as such for tax purposes."

The issue involved in this proceeding presents a Federal question on the interpretation of the U. S. Internal Revenue Code and is of national importance in the administration of the Federal income tax statutes with its impact extending into the very heart of the financial community. The holding of the Courts below is a complete reversal of methods of financing real estate transactions long considered legitimate by the legal profession not only with reference to stockholder-corporation relationships but also with reference to relationships among creditors.

Counsel for petitioner has been reliably advised that litigation involving this point is constantly increasing before the Courts most of which could be obviated if the Supreme Court would accept jurisdiction in this case and determine the applicable principles and set uniform standards among the circuits.

Conclusion

Since decisions of U. S. Courts of Appeal in other circuits are in conflict with the Courts below in this proceeding as to principles of Federal tax law involved and the application of those principles to stated facts, and since the issue presented is of substantial nationwide importance affecting thousands of taxpayers, this Honorable Court should grant taxpayer's petition for a writ of certiorari and hear the proceeding.

Respectfully submitted

BERNARD WEISS,
Counsel for Petitioner

Dated: May 20, 1957

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APPENDIX

STATUTES

U. S. Internal Revenue Code of 1939 adopted by Act of February 10, 1939, Chap. 2, 53 Stat. 1-504 applicable to this proceeding:

Section 23. Deduction from Gross Income.

In computing net income there shall be allowed as deductions:

* * *

(a) Interest.—All interest paid or accrued within the taxable year on indebtedness except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after Sept. 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

REGULATIONS

Section 29.23(b)-1. (Original, Oct. 26, 1943)
Interest.

Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds or (in case of a taxpayer not an original subscriber) obligations of the United States issued after Sept. 24, 1917, the interest upon which is wholly exempt from tax is not deductible. * * *

DECISION

U. S. Court of Appeals for the Second Circuit, issued 3/28/1957

U. S. COURT OF APPEALS
for the Second Circuit
No. 186 — October Term 1956
Argued Mar. 5, 6, 1957 Decided Mar. 28, 1956
Docket No. 24359

241 CORPORATION,

Petitioner

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

Medina and Waterman, Circuit Judges and Galston, District Judge

Petition to review a decision of the Tax Court, Stephen E. Rice, Judge.

The Tax Court disallowed deductions claimed as interest paid on indebtedness under Internal Revenue Code of 1939, Section 23(b), holding that advances made by stockholders to the taxpayer corporation were capital contributions rather than loans. T. C. Memo 1956-174. Affirmed.

Bernard Weiss, New York City
for Petitioner

Charles K. Rice, Assistant
Attorney General,
Washington, D. C.
(Lee A. Jackson and
Morton K. Rothschild,
Attorneys, Department of
Justice, Washington
For Respondent.

Per curiam:

Affirmed on the findings of fact and opinion of Judge Rice, T. C. Memo 1956—174.

JUDGMENT

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York on the twenty-eighth day of March, one thousand nine hundred and fifty-seven.

Present: Hon. Harold R. Medina
Hon. Sterry R. Waterman, Circuit Judges
Hon. Clarence G. Galston, District Judge

Circuit Judges

241 Corporation,
Petitioner

v.

Commissioner of Internal Revenue,
Respondent.

APPEAL FROM THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of record from The Tax Court of the United States and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

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Kelley, John, Co. v. *Commissioner*, 326 U. S. 521 — 5

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Rowan v. *United States*, 219 F. 2d 51 — 6

Talbot Mills v. *Commissioner*, 326 U. S. 521 — 5

Statute:

Internal Revenue Code of 1939:

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Sec. 115 (a) (26 U. S. C. 1952 ed., Sec. 115 (a)) — 2

439497—57

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 1019

241 CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The opinion of the Tax Court (R. 33–44)[1] is a memorandum opinion, and therefore is not officially reported. The *per curiam* opinion of the Court of Appeals (Pet. 1a–2a) is reported in 242 F. 2d 759.

JURISDICTION

The judgment of the Court of Appeals (Pet. 3a) was entered on March 28, 1957. The petition for a writ of certiorari was filed on May 22, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

[1] Record references are to the appendix to the taxpayer's brief filed in the Court of Appeals.

QUESTION PRESENTED

Whether advances made to the taxpayer by its stockholders were contributions to capital, and not loans upon which interest was properly accruable under Section 23 (b) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 23.)
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
>
> (a) *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 115.)

STATEMENT

The facts as found by the Tax Court (R. 34–40) may be summarized as follows:

The taxpayer corporation was organized in 1945,

under the laws of New York, by a group of five individuals for the purpose of taking title to certain real property in New York City, the purchase price of which was about $1,840,000. (R. 34.) The original plan was for the taxpayer to assume a first mortgage of about $1,540,000 and obtain a second mortgage of $250,000, and for the stockholders to advance $50,000, of which $3,000 was to be considered as capital. (R. 34–35.) Later, the stockholders found that they would have to advance $150,000, of which $3,000 was to be capital and the balance, or $147,000, was to be regarded as a loan. The taxpayer issued 30 shares of stock with a par value of $100 each; 5 shares to each of four stockholders, and 10 shares to the remaining stockholder; the stockholders made additional advances in the aggregate amount of $147,000 in exact proportion to their stockholdings. (R. 35.)

The taxpayer's minutes of August 1, 1945, include the following resolution (R. 36–37):

> On motion duly made, seconded and unanimously carried, it was
>
> *Further resolved* that the corporation borrow such additional moneys as it may require from time to time from Jacob R. Schiff, Samuel Rudin, Edward Rudin, Seymour H. Gross and Manuel G. Sydney, for the purpose of carrying on its regular business, and any such loans shall bear interest at the rate of 10% per annum.

In addition to the advances of $147,000, referred to above, the stockholders made additional advances during the years 1945 to 1948, inclusive, which were, for the most part, in proportion to their stockholdings. (R. 37, 41.)

The advances were not evidenced by notes or similar instruments, and were not secured by the pledge of collateral. They were carried on the taxpayer's books as loans payable, and were not subordinated to the claims of general creditors. There was no definite arrangement as to payment of either principal or interest. Such payment was entirely dependent upon the taxpayer's earnings. There was an agreement among the stockholders restricting the transfer of stock by the stockholders, and there was testimony by one of the stockholders that if notes had been issued for advances to the stockholders, such notes would have been subject to the same restrictions as to transfer. (R. 37–38.)

All of the advances made by the stockholders to the taxpayer were repaid during the years 1948 through 1952; however, none of the interest was paid until 1952, at which time about $16,000 was paid, leaving about $73,000 unpaid at the time of the hearing before the Tax Court. (R. 39–40.) The taxpayer did not pay the interest as it accrued, because it did not have sufficient funds. It paid off the principal as frequently as it could, and so reduced interest charges. The taxpayer did not accrue interest on the accrued unpaid interest. (R. 39.)

The taxpayer, which kept its books on an accrual basis (R. 34), accrued interest at the rate of 10 percent per annum, pursuant to the corporate resolution dated August 1, 1945 (R. 39). Interest deductions were claimed by the taxpayer on its federal income tax returns for the taxable years ended June 30, 1946, June 30, 1947, and June 30, 1948, in the amounts of

$14,709.49, $17,371.16, and $17,995.84, respectively, with respect to its accruals of interest on stockholders' advances. The Commissioner disallowed the deductions, and the Tax Court upheld him on the ground that the advances to the taxpayer by its stockholders were contributions to capital and not loans. (R. 40, 42.) The Court of Appeals affirmed the decision of the Tax Court in a *per curiam* opinion. (Pet. 1a–2a.)

ARGUMENT

The decision of the court below is correct. It affirms the Tax Court's conclusion that the advances made to the taxpayer by its five stockholders, under the circumstances of this case, were contributions to capital and not loans upon which interest was properly accruable under Section 23 (b) of the Internal Revenue Code of 1939, *supra*, p. 2. The Tax Court properly applied the principles established by this Court in *John Kelley Co.* v. *Commissioner* (decided with *Talbot Mills* v. *Commissioner*), 326 U. S. 521, where it was held that whether a corporate payment[*] constitutes deductible interest or a nondeductible dividend distribution presents a question of ultimate fact in each case, depending upon whether the true relationship of the parties is that of debtor-creditor or corporation-stockholder. In determining that relationship, this Court held that consideration should be given to the characteristics of the obligations in question and

[*] The taxpayer here was on an accrual basis. (R. 34.) It did not make any interest payments until 1952, which was after the taxable years; at that time it paid interest aggregating about $16,000; the balance, or about $73,000, had not been paid at the time of the hearing in the Tax Court. (R. 39–40.)

the surrounding circumstances, and remarked that no one characteristic can be said to be decisive. The Tax Court applied those principles here. (R. 41.)

In the instant case, the Tax Court found that the stated capital of $3,000 was wholly indaequate to finance the purchase of the properties (the cost of which was more than $1,800,000 (R. 34)), and that the balance of the initial advances, $147,000. represented part of the purchase price; that the above-mentioned initial advances were in exact proportion to the stock interests of the shareholders; and that when it was found later that additional funds were required by the taxpayer, the majority of such additional advances were made according to the equity interests of the stockholders. (R. 43–44.) The Tax Court also took into consideration the fact that there were no notes, and no evidence of a fixed date of payment. (R. 42-43.) There was substantial evidence to support these findings (R. 34–40), as the Court of Appeals held in its *per curiam* opinion (Pet. 1a–2a). In view of the concurrent factual determinations of the courts below, and the absence of a conflict of decisions,[3] further review is not warranted. Cf. *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), certiorari denied, 352 U. S. 1031, and *Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498 (C. A. 2d), certiorari denied, 353 U. S. 946.

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[3] In *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 (C. A. 9th), and *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C. A. 2d) (Pet. 14), there were written evidences of indebtedness, whereas here there were no notes and no maturity dates for repayment of the advances (R. 37, 42). In *Rowan* v.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
LEE A. JACKSON,
MORTON K. ROTHSCHILD,
Attorneys.

JUNE 1957.

United States, 219 F. 2d 51 (C. A. 5th) (Pet. 10), the initial payment was not made for acquisition of capital assets, while it was in this case. (R. 34–36.) In *Pierce Estates* v. *Commissioner*, 195 F. 2d 475 (C. A. 3d) (Pet. 11), there was no question as to whether the advances by the stockholders were contributions to capital or loans; the Tax Court had decided that the advances were loans, and the Commissioner did not take a cross appeal on that issue; the only issue on appeal was the amount of interest which the taxpayer could accrue as a deduction in the taxable year, and that depended upon whether, under the terms of the notes, accumulated interest accrued in the taxable year.